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Subject: CFC Ownership Through Informal Voting Arrangement

This is in response to your question regarding whether a person that transfers nominal or mere title ownership of stock in a foreign corporation could nevertheless be considered under the provisions of subpart F to be a U.S. shareholder of that foreign corporation (which would then be a CFC), as well as your question regarding the statute of limitations and penalties that would apply for failure to file a Form 5471 for such entity.

CFC Ownership and Informal Voting Power

The term controlled foreign corporation means any foreign corporation of which more than 50 percent of either the total combined voting power of all classes of stock of the corporation entitled to vote or the total value of the stock of the corporation, is owned by United States shareholders on any day during the taxable year of such foreign corporation. I.R.C. § 957(a). Mere title ownership is not determinative of who holds the voting power of the stock; any arrangement to shift formal voting power away from U.S. shareholders will not be given effect if, in reality, voting power is retained. Treas. Reg. § 1.957-1(b)(2).

The regulations provide examples of when voting power will be considered to have been retained and, thus, the U.S. person in question will be considered to be a U.S. shareholder of a CFC. Example 5 of Treas. Reg. § 1.957-1(c) illustrates that a foreign corporation may qualify as a CFC solely as a result of a U.S. shareholder actually owning more than 50% of the voting power of the corporation where nominal ownership and voting power is vested in a non-resident alien.

In Example 5, N, a U.S. person owns 50% of the outstanding shares of foreign corporation R, foreign corporation S owns 48% of the outstanding shares, and the remaining 2% are nominally owned by a non-resident alien. However, because the non-resident alien regularly acts as an attorney for N, reduces fees in conjunction with dividends received on the shares, and permits N to borrow against the shares, the example finds an implied agreement for N to "hold dominion" over the stock and the corporation is determined to be a controlled foreign corporation because N "owns" a total of 52% of the stock. This is the case despite the fact that the non-resident alien actually votes his shares at shareholder meetings.

The regulations under § 957 have been applied by courts to find U.S. ownership in CFCs where only informal voting power was retained by a non-title owner.

In *Garlock v. Commissioner*, 489 F.2d 197 (2d Cir. 1973), a U.S. corporation reduced its title ownership in the voting stock of a Panamanian subsidiary from 100% to 50% in order to avoid tax under the recently enacted CFC provisions in the Code. (If U.S. ownership by

vote and value had been no more than 50%, the subsidiary would not be considered a CFC.) In the recapitalization, preferred shares were issued to foreign investors who nominally received 50% of the voting power. *Garlock*, 489 F.2d at 198.

The court nevertheless held that the voting power of the stock was in reality retained by the U.S. corporation, which was therefore required to include subpart F income from the subsidiary. *Id.* at 202. In reaching its determination that the voting power of the preferred shareholders was illusory, the court considered that the stock had been deliberately placed with investors who would vote their stock as instructed, the transfer of shares was prohibited without prior written consent, and even though the investors could have technically voted independently, there was no evidence that they did, and the board in fact always consisted of the U.S. corporation's officers. *Id.* at 200-202. Also of relevance was a report by the president of the U.S. corporation to the board of directors of the subsidiary, which proposed the recapitalization and explained that the reason was to avoid the tax result at issue. *Id.* at 201.

Another case involving this regulatory provision is *Koehring Co. v. Commissioner*, 583 F.2d 313 (7th Cir. 1978). In *Koehring*, a foreign corporation was determined to be a CFC based on an informal side agreement granting actual voting power. *Koehring*, 583 F.2d at 319 ("[T]he U.S. shareholder has arranged things in such a way that he has not actually divested himself of effective control").

Filing Requirements and Penalties

The Form 5471 filing requirements apply to all U.S. shareholders of a CFC. There is no exception for a person who is a U.S. shareholder as a result of informal voting power arrangements. Consequently, the statute of limitations and penalty provisions that apply when a U.S. shareholder of a CFC fails to file Form 5471 will apply to an individual who, though not the nominal title owner of shares, is a U.S. shareholder as a result of an informal voting power arrangement.

Thus, when a person who is a U.S. shareholder as a result of informal voting power arrangements fails to file Form 5471, the statute of limitations for assessing tax imposed with respect to any tax return, event, or period to which the information required to be reported on the form relates will not begin to run under § 6501(c)(8) until the shareholder files the required Form 5471. Similarly, a person who is a U.S. shareholder as a result of informal voting power arrangements is subject to the penalties under § 6038 for failure to file Form 5471.

If you have further questions about CFC ownership, please contact _____ on _____ or me on _____.